RAILROAD WEEK IN REVIEW

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"The merchandise side business is the area that most benefits from the change in the operating model from the old way of looking at things — running trains and forgetting where your customers' cars were half the time on the railroad. The merchandise franchise is 66 percent of our business and, for a long time, went to truck because we didn't have a service product that met our customer needs." — CEO Jim Foote, CSX, Q4 conference call Q&A

"If our assets sit too long at a customer origin or destination, those assets aren't turning. If we have to wait for customers to load or unload, that's going to cause a disruption in the network." Mike Naatz, Chief Commercial Officer, KCS, Q4 Q&A

CSX opened the 4Q2018 earnings season with total revenue units up three percent percent in the quarter, hitting1.6 million; merchandise carloads including automotive grew four percent. Freight revenues came in at $3.0 million, up nine percent; RPU gained six percent. (CSX reported RPU on total revenues, not freight revenues, so up seven percent.)

For the year, total revenues increased seven percent to $12.3 billion, fuel surcharges jumped 81 percent to $665 million, "other" revenue gained 34 percent to $582 million. Back these out and freight revenue is $11 billion, up four percent.

For the quarter, operating expense was $1.9 billion, up nine percent; ops income was $1.2 billion, up 11 percent, and the operating ratio was a highly respectable 60.3, but just 41 basis points better than last year. Net before taxes was $1.1 billion, up 12 percent. Backing out and adjusting for the 2017 tax credit, fourth quarter eps was $1.01, up 58 percent. The share count after dilution declined seven percent.

Cash from operations was $4.7 billion, up 34 percent; capex was $1.7 billion, down 15 percent; share repos cost $4.7 billion, up 137 percent. There was $3 billion of new debt issued, up 250 percent, so free cash flow after dividends and repos was a negative $2.5 billion, 103 percent more than last year.

So, even though the carload results were somewhat underwhelming, I found the earnings call Q&A refreshing because they spoke in railroad vernacular, not analyst-speak. Short operators are clearly enabled to make things happen locally, and if there is resistance, you can say, "Well, your president said on the call…" Some quotes:

> OT arrivals are not where they ought to be; we're doing a lot of root-cause failure analysis. Are there systemic issues that cause locomotives to fail, which can cause a train not to get across the river? Are there mechanical issues? Are there engineering issues that we need to address? Are there crew-balancing issues that we need to address?

> We’re striving to reverse and improve the overall core product of the intermodal business. We are not just driving people off just to get rid of bad business. We are fixing and improving the intermodal franchise and the intermodal network of the CSX so that it can grow, and grow profitably and consistently in the future.
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> On line sales, in 2018 we did have line sales that had both cash and gain impact. It's a little unusual to have the gain impacts on line sales. Those were lease conversions that drove some operating income favorability. In terms of 2019, we do have a couple of lines sales in the works. They will be cash-accretive but not necessarily operating income-accretive.
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> There comes a point in time when all of a sudden you start to see above-average growth for a railroad company that has adopted [PSR], because the quality of the service becomes so much better than it historically was.

Kansas City Southern reported record fourth quarter revenues of $694 million, an increase of five percent, on 588,200 revenue units, essentially unchanged; system average RPU increased 3.4 percent to $1,120. Operating expense was held to a 3.5 percent gain, producing record fourth quarter adjusted operating income of $248 million, excluding a gain on insurance recoveries related to hurricane damage. The operating ratio came in at 63.1, compared to 64.0 in the 2017 fourth quarter. Net income was $161.8 million, up 13 percent after adjusting for the 2017 tax windfall.

Merchandise carloads grew two percent on healthy gains in chemicals (both STCCs), ores/minerals, aggregates, and crude oil, offset by decreases in forest products, metals/scrap, and frac sand. The 2019 outlook calls for growth in intermodal, automotive, industrial chemicals, petrochemicals, and heavy crude oil — in all, some 65 percent of volume. Metals, forest products, agricultural goods, coal, and frac sand will do less well.

Out on the railroad, dwell is down and velocity is up, thanks mainly to operating changes South of the Border. KCS continues its PSR initiative, using those characteristics and disciplines best suited to the KCS network. The fact that a third of KCS volume is local is an advantage, as is the volume of business done with connecting PSR Class I railroads. Chief benefits will be bringing train-starts under control, turning cars faster (with customers’ help), and improving revenue ton-miles per available horsepower and per employee.

To assist in this process, KCS last month hired former CN exec Sameh Fahmy as a consultant to assist in the design of the company's PSR rollout and operational strategy. He brings to the table 12 years of work with Hunter Harrison plus another two decades in CN engineering and mechanical management roles. He retired from CN in 2013, around the time Jim Vena was named COO, and will be working with Vena in the latter’s new UP capacity — highly appropriate as UP is the largest Class I interchanger partner with KCS.

Genesee & Wyoming December same-store carloads increased 8.4 percent to 137,797 units after deducting nearly 2,000 carloads for divested shortline names. As usual, bulk commodities — coal/coke, agricultural products, aggregates — represented 40 percent of the total; forest products, STCC 28 chemicals, and metals added another 40 percent.

You'll note that most of the top 80 percent of carloads are commodities with little time value and where one 2x4 or ton of sand is no different than any other. This, I fear, is the curse of the shortline business. But it's also a blessing because the Class Is don't call on many of these customers and short lines do, adding the value of local customer care whereas the Class Is adds little added-value beyond the line haul — which, absent the feeder lines' efforts, would be much diminished.

For the year, GWR handled 1.7 revenue units, up six percent, triple the AAR percentage volume increase. The month-to-month change, however, continues to be uneven: up 12 percent one month, down seven percent the next. Unfortunately, that's what can happen when you're doing thousands, not million, of carloads. Happily, GWR has the depth to cope.

Watco's Texas & New Mexico Railway (TXN) has teamed up with Vista Proppants & Logistics to run 25-car shuttle trains between a local sand mine and the Vista loading terminal, 12 miles away, north and west of Monahans, Texas. This is the first instance of moving sand by railroad *within* the Permian Basin.

Vista management says, "Increased road congestion is leading to inefficiency in truck turn times, which results in higher costs for all parties. Through the development of a rail-served transload terminal facility located very close to our West Texas mine, we will be able to deliver our products mine-to-terminal via railcar for truck delivery beyond into key markets in the Permian."

The TXN operates more than 100 miles of track in New Mexico and Texas, interchanging with the UP at Monahans, Texas, and running north to Lovington, New Mexico. The railroad primarily handles oilfield commodities such as drilling mud and hydrochloric acid, frac sand, pipe, and petroleum products including crude oil. Well done, TXN.